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Deepening the internal market in the banking sector

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The Banking Union

Why does the monetary union imply a banking Union?

If the Banking Union can be defined as a regulatory and supervisory system applied in a unified manner to all the banks active in a monetary zone, it is natural then to associate the concept of Banking Union to monetary union.

Indeed, it is through the banks that monetary policy can be transmitted to the economy. It is through the banks that the instruments of this policy (changes in central bank rates, acquisition of financial instruments on the markets, rediscount facilities, reserve requirements…) can influence the economy.

Hence, it is justified to bestow on central banks the responsibility of supervising the banking sector of their jurisdiction and ensuring its stability and orderly functioning. It is the way systems work under national models: even when a central bank is not legally in charge of banking supervision, in fact it cooperates closely with the competent authority when it does not duplicate its responsibilities.

From this perspective, it is strange that until 2014 i .e. during 15 years of the creation of the Euro, nobody has seemed to be concerned by banking union issues.

Indeed, we only started to tackle this question after 2010 when the markets, with the Greek crisis, sanctioned banks which presented problematic characteristics.

Let us dwell on these characteristics:

- The link between banks and States: when States are sanctioned by the market because of their excessive indebtedness, and when commercial banks are saddled with huge amounts of sovereign instruments issued by their own country, the weakening of State ratings is automatically reflected in banking balance sheets. Fundamentally, the problem comes from lack of fiscal discipline, excess liquidity created by lasting loose monetary policy as well as from the lack of macroeconomic coordination, much more than from banking weaknesses ;

- The growing magnitude of non-performing loans: they derive from economic problems, recessions that have in some cases sometimes durably hit some European countries – often those who engaged in real estate overheating at the beginning of the years 2000. Basically, the problem came from a single monetary policy applied to very heterogeneous States in terms of the quality of their economic governance and their inflation: the "peripheral" countries with higher inflation took "advantage" of real interest rates which were much lower than in the "North". This only compounded the existing heterogeneities and differences. Here also, one notes the weakness of policies and of macroeconomic surveillance.

Thus, we only started to look at the problem when the difficulties appeared and in a situation of crisis. The immediate question was: "How to react to the banking crisis that was threatening some of the Members of the Union and the Union at large? " . In haste, authorities implemented bail out mechanisms. But they were careful to make those mechanisms conditional, which actually supposed common supervision. This is how the idea of a Banking Union appeared: more as a consequence of the crisis rather than as a founding concept.

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Why this historical reminder?

Because it teaches us two things that we should have in mind when we touch the subject of the Banking Union.

- The Banking Union was not conceived to address the fundamental issues that explain the most serious banking difficulties (unsustainable fiscal deficits and debts, lack of a true macroeconomic surveillance leading to increasing NPIS …).

- The Banking Union had the great merit of creating in 2014 a single regulatory and supervisory framework for banks in the euro area. But this unification through the SSM cannot solve in itself the problems of substance of the European banking system. These problems are related to the history touched upon above and which translate into lack of trust between the Members of the Union, regulatory fragmentation, excessive number and dispersion of banks in the EU and relatively low efficiency of the banking market in Europe.

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Let us examine further this issue.

It is said that the banking sector in Europe is too fragmented, not concentrated enough and oversized:

In fact, since the 2008 crisis, mergers and acquisition in the banking sector have practically disappeared (170 billion euro transactions in 2007 against only 10 in 2015).

During the same period, the share of cross-border credits in the European total has declined by 40%.

Lastly, banking concentration appears weak in Europe (the five major banks in the US have a market share of 40%, double that in Europe)

Why have we seen such a decline in banking M&As? For three major reasons:

- The largest banks (GSIBs) are penalized in terms of their capital requirements in proportion of their size. One can understand why they do not wish to be bigger given these disincentives.

- Furthermore the largest banks are reluctant to absorb banks burdened with NPLs all the more so since a European securitization market is still underdeveloped due again to regulatory constraints.

- Lastly ring-fencing policies (capital, liquidity, bail-in instruments,…) by host supervisors, applied to subsidiaries of transnational banking groups, which are located in their countries, discourage large EU banks to reinforce and increase the number of their subsidiaries in the EU.[1]

The fact Europe does not benefit, contrary to the United States, from a true single capital market and a vibrant cross-border banking system, is also a serious handicap. We need true pan European banks in order to ensure the sovereignty of our continent in financing. This is a pre-condition for an effective Capital Market Union.

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[1] *One can add that another obstacle to merger activity is the structure of the banking industry: only 30% of the significant banks in the euro zone (directly supervised by the SSM) are publicly traded companies. Most of the non-listed banks in the Eurozone are saving banks, regional banks or cooperative banks.*

In fact there is much less unification than 10 or 15 years ago and the doom loop between banks and their sovereigns is far from being resolved[2].

What are the consequences of this geographical "nationalization" of the European Banking system and its regulatory framework?

The consequences of this fragmentation are severe and notably mean:

- Weak profitability of banks (in 2017, according to Reuters data, the return on equity was 3,9% on average in the European Union as opposed as 9,5% in the United States) ;

- Without M&As, reducing costs through economies of scale is more difficult and in addition there is much less transfer of technology and knowledge ;

- The EU resistance to asymmetric shocks is weaker: in the United States the capital and credit markets absorb alone more than 50% of the consumer impacts of such shocks; in Europe is only 10% because of the lack of capital mobility of credit which stays within national borders. In total, including the fiscal element, more than 2/3 of the shocks are absorbed in the US whereas it is only 1/5 in Europe, which is of course an avenue towards deflationary adjustment solutions in our continent.

It is clear that « ring fencing » is a significant element to explain these consequences.

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[2] *According to EBA, on average, 65% of a medium sized bank's Tier 1 capital, is on the domestic sovereign, but in the whole distribution there are banks which have up to eight or nine times their Tier 1 capital on the domestic sovereign. Regulators are asking the banks to have liquidity buffers, which are essentially composed of sovereign exposures. This liquidity buffer should be mark to market, because banks must be ready to sell this in the market if there is liquidity stress. There should also be some incentives to act on the tail of distribution where there is excessive concentration on the domestic sovereign.*

If we continue to condone ring-fencing and hinder cross-border banking consolidation, the risk is to see banking groups eventually split into branches instead of subsidiaries.[3]

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So fragmentation of banking is strongly embedded in the European Union:

- It is in part the result of history, notably economic divergences since the year 2000 between Member States, the sovereign debt crisis of 2010 as well as the deterioration of confidence which followed ;

- It seems to me that neither politicians nor regulators are ready today or perhaps willing to really deal with these “fragmentation” issues ;

- This fragmentation is also underwritten by a regulatory system which, de facto, blocks banking mergers and encourages domestic activity as well as domestic prudential focus;

- It cannot be dealt with by the SSM because ring fencing is in conformity with European banking law and regulation. Even the cross-border liquidity of a pan European Banking group is treated prudentially as national segments and not as a consolidated entity. It is compounded further by European regulatory complexity (internal MREL, the demands of HQLA that are calculated at the national level and result in surplus liquidity in certain countries to the detriment of a rational consolidated management).
  In fact, contrary the ring fencers’ beliefs, defining prudential requirements at the consolidated level and not on a solo basis would contribute to reinforce financial stability of these groups and of the region.

[3] *Liquidation in this case would be much easier since home insolvency law would apply to all the branches located in the EU.*

- The international standards for the prudential treatment of GSIBs do not recognize the Eurozone as single jurisdiction and thus treat cross-border operations within the zone as any international exposures. But it is fair to say that not many governments and regulators seem to be favorable to a single jurisdiction…

- The unfolding of each phase of the Banking Union (concerning banking resolution and deposit guarantees) has led to hidden agendas and skepticism. The real debate has become: "whether to reduce the risk before risk sharing or to do it in parallel".

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In conclusion of this personal analysis I would like to sketch some possible policy orientations:

- We should not believe that the subject is purely technical and can be only be resolved by technical measures ;

- But let us, modestly and by working hard, try to make progress on several fronts (not to mention, of course, the critical necessity to continue structural reforms which remain indispensable and to correct fundamental on going current account disequilibria which are threatening the monetary union) ;

- Beyond the current issues that are being discussed at the EU level (backstop for the Resolution Fund, liquidity after resolution,…) let me underline the following key points :

a. Of course continue to reduce the NPLs[4] (being observed that the predominantly *domestic* focus of European banks amplifies the link between national economic developments and financial stability in individual countries).

b. Find a pragmatic agreement between the SSM and host national authorities on ways to abolish ring-fencing by agreeing arrangements by which the host authorities have legal guarantees in case of banking difficulties.

   These guarantees, provided, as an option, by the parent company of transnational groups to their subsidiaries, should be agreed now and in advance of possible future crises.
   In order to create a climate of confidence and trust, host countries should be associated and involved upstream in the establishment of living wills.

c. The anomaly of the present organization of failing or likely to fail banks comes from a striking asymmetry. One the one side the banking groups are supervised and resolved at the EU level while, on the other side, their liquidation - when it is decided by the Single Resolution Board - is managed at the national level (entity by entity). This can require public money of the Member State and hence only reinforce the lethal link between the banks and the State.

d. Make more predictable the resolvability of failing banks whatever their size by a common application of the "public interest criteria".

   Given the impossibility of harmonizing all insolvency laws, it would be as a minimum highly desirable and possible to align the outcomes of insolvency law in the EU to ensure their full consistency with the EU resolution regime.

[4] *As a percentage of total loans, the NPLs have decreased on average since 2013 from 7% to 5% in the euro area. But a number of countries in Europe are still around 20% (e.g. Italy, Portugal, Ireland, Bulgaria, Slovenia) not to mention Greece and Cyprus (above 40%) - source : KPMG "Non-Performing Loans in Europe", August 2018.*

We should indeed align the EU crisis management framework and national insolvency laws. Currently, a bank that is declared failing or likely to fail under the BRRD and the SRM Regulation does not always meet the conditions that would make it subject to national insolvency proceedings. In fact, under national legislation present and actual illiquidity is usually required if insolvency proceedings are to get under way. But at European level, not only actual but even likely illiquidity can be grounds for declaring a bank failing or likely to fail.

In addition, the EU crisis management framework should avoid situations whereby creditors of the same type in subsidiaries are treated differently or be seen as discriminated against.

e. Furthermore, it could happen that some medium size banks under the SSM supervision might be in difficulty to raise at acceptable conditions the required level of MRELs. In that case the relevant banks could in principle only be liquidated and the possible ultimate outcome might well be to resort again to the old national bail out in case governments fear a disorderly liquidation;

f. Achieve an agreement in the Council on the transformation of the European Stability Mechanism (ESM) to make it a Community organisation rather than an intergovernmental one;

g. Reach an agreement on the deposit insurance mechanism inter alia, to show that political commitments taken in 2012 are fulfilled.

h. Agree on a reasonable and pragmatic reinforcement of ESAs, a matter overdue.

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Baron Louis, Minister of Finance in France, said to his government around 1820 :

" Faites-moi de la bonne politique et je vous ferai de la bonne finance", which can be translated as : " Make good policies, and I will bring you good finance ".

We could say under his tutelage and inspiration :

" Do the structural reforms, eliminate excessive disequilibria, converge our economies symmetrically, show a little more kindness on risk sharing and I will bring you Banking Union ".

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